No. 209

In the Supreme Court of the United States

OCTOBER TERM, 1946

ADAM A. ADAMS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The opinion of the Tax Court (R. 95–109) and the dissenting opinions (R. 109–111) are reported at 5 T. C. 351.[1] The opinion of the Circuit Court of Appeals (R. 114–117) is reported in 155 F. 2d 246.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 16, 1946. (R. 118.) The petition for a writ of certiorari was filed June 18, 1946, and was granted on October 14, 1946.

[1] The Division report (R. 83–94) is not properly a part of the record. Section 1118 (b), Internal Revenue Code (26 U. S. C. 1940 ed., Sec. 1118).

(R. 119.) The jurisdiction of this Court rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Pursuant to a plan of recapitalization, the taxpayer-stockholder exchanged his stock for new stock and debentures in the same corporation. The debentures were worth, not less than $164,000 when distributed and the corporation had accumulated earnings and profits of at least that amount. The corporate books showed no change in surplus as a result of the transaction. The principal question is whether the recapitalization, pursuant to which the exchange was made, was undertaken for a corporate business purpose, so that it is to be given effect as a tax-free reorganization under Section 112 of the Internal Revenue Code and Section 19.112 (g) of Treasury Regulations 103.

2. Whether the distribution of the debentures effected a distribution of the accumulated earnings and profits, taxable as an ordinary dividend under Sections 22 (a) and 115 of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set out in the Appendix to the Commissioner's brief in *J. Robert Bazley* v. *Commissioner*, No. 287, present Term, a companion case to be argued consecutively with the present case.

STATEMENT

The pertinent facts found by the Tax Court (R. 96–101) may be summarized as follows:

In the taxable year 1941 the taxpayer was principal stockholder and president of Newark Theatre Building Corporation, a New Jersey corporation, which had an authorized capital of 6,000 shares of common stock of a par value of $100 per share. On January 26 of that year the taxpayer owned 5,903 shares of this stock out of a total of 5,914 which were issued and outstanding. (R. 96.)

On December 6, 1940, the directors of the corporation met to consider the desirability of revamping the capital structure of the company. The president pointed out that, in his opinion, the whole capital structure was not well balanced, and that it was not good business to have so top-heavy a capital set-up. He stated that a simple plan of recapitalization could be evolved which would bring about the desired change at comparatively little expense to the company; that he had consulted legal and accounting counsel, who could see no difficulty in consummating the plan of recapitalization. (R. 96–97.)

The following plan was then proposed and adopted (R. 97):

> (1) A reduction in the authorized capital stock from $600,000 represented by 6,000 shares of a par value of $100 each, of which 5,914 shares, or $591,400 are issued and

outstanding, to $295,700, to be divided into 5,914 shares without nominal or par value.

(2) The issuance of debenture bonds in the aggregate principal amount of $295,700, bearing interest at the rate of six percent per annum, payable semi-annually, the principal to be payable in 20 years from the date thereof, plus 5,914 shares of the new no-par common stock, in exchange for the present shares of capital stock, on the basis of one $50 bond and one share of no-par value common stock for each of the present $100 par value shares surrendered.

The directors adopted the appropriate resolution to amend the certificate of incorporation to provide for the reduction of authorized capital, and the issuance of no-par value stock, and the stockholders duly ratified and approved the actions of the directors with respect thereto. (R. 97.)

It was anticipated that there would be a saving of New Jersey franchise taxes in excess of $400 per year and a reduction of the corporation's federal income tax liability in substantial amounts each year by the deduction of the interest paid on the bonds. (R. 97.)

The recapitalization was carried out in accordance with the plan. Taxpayer on January 27, 1941, surrendered his 5,903 shares of $100 par value stock, and received for each share thereof one share of no-par value stock of a stated value

of $50, and one $50 debenture bond. The bondholders were to rank *pari passu* with unsecured creditors in event of dissolution. (R. 98.)

On January 26, 1941, the corporation had accumulated earnings and profits available for distribution in a sum not less than $164,514.82. The new debentures regularly earned and paid the interest due on them, and when received by the taxpayer had a value not less than $164,208.82. (R. 101.)

The corporate books showed no change in its surplus account following or as a result of the distribution of the bonds. The old par capital stock account was debited in the sum of $591,400, a new no-par capital stock account was credited with $295,700, and the balance of $295,700 was credited to a "Debenture Payable" account. (R. 98.)

The Commissioner determined that the taxpayer received a taxable dividend in 1941 in the form of debenture bonds to the extent of the corporation's accumulated earnings in the amount of $164,208.82, and accordingly determined a deficiency in his income tax for that year. The Tax Court explicitly found that "the recapitalization and distribution of debentures above described had no legitimate business purpose" (R. 101), which would qualify the transaction as a tax-free reorganization within the meaning of Internal Revenue Code Section 112, and that such earnings

as the corporation had were distributed by means of the debentures to the extent of their value. (R. 108–109.) Accordingly, the Tax Court sustained the Commissioner's determination. (R. 109.)

The Circuit Court of Appeals affirmed. (R. 114–117.)

ARGUMENT

This case presents the same basic issues as those in the *Bazley* case, No. 287, and reference is here made to our brief in that case which sets forth in full the basic arguments in support of the Commissioner's position both there and here.

As pointed out by the Circuit Court of Appeals (R. 114), the reasons given for the recapitalization here differ somewhat from the ones in the *Bazley* case, but the differences do not change the result; here, as in the *Bazley* case, the Tax Court specifically found (R. 101) that the recapitalization and distribution of debentures had no legitimate corporate business purpose, and the Circuit Court of Appeals accepted that finding (R. 116). The principal purpose assigned was that the creation of debenture bonds would facilitate refinancing. The Tax Court did not believe that this purpose had actually existed. (R. 102.) The second reason, according to the taxpayer, was his desire to give some securities of the corporation to his sons without surrendering any of his own stock control. (R. 102–103.)

This was a reason purely personal to the taxpayer and served his individual interests as distinguished from the corporate interests. The remaining two reasons were the saving of corporate income taxes resulting from the deduction of interest paid on the bonds and the saving of New Jersey franchise taxes resulting from the decrease in the amount of stock. (R. 103.) These asserted reasons promised such slight advantages to the corporation when compared with the burdens imposed by creating the corporate indebtedness that the Tax Court correctly concluded that the fact that the taxpayer was the dominant stockholder evidently largely accounted for the transaction. (R. 103–104.)

The other point of departure from the *Bazley* case, also noted by the Circuit Court of Appeals (R. 116), is that here the company's book surplus was not affected by the distribution. However, it in fact had available earnings and profits of some $164,000, accumulated since February 28, 1913, and the debentures were worth at least that amount at the time of distribution (R. 101). That is enough to sustain the tax.

It is settled that the taxpayer's accounting methods are not controlling for tax purposes (*Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, 187; *Helvering* v. *Midland Ins. Co.*, 300 U. S. 216, 223; *Commissioner* v. *Wheeler*, 324 U. S. 542, 546; *Commissioner* v. *Estate of Bedford*, 325 U. S. 283,

292), and it is also settled that every distribution must be deemed to be made from earnings or profits accumulated after February 28, 1913, if there are any on hand and available for distribution. The statute (Sec. 115 (b), Internal Revenue Code) expressly so provides, and such provisions are unquestionably valid. *Edwards* v. *Douglas*, 269 U. S. 204, 216–217; *Helvering* v. *Canfield*, 291 U. S. 163; *Beretta* v. *Commissioner*, 141 F. 2d 452 (C. C. A. 5th), certiorari denied, 323 U. S. 720; *Tate* v. *Commissioner*, 97 F. 2d 658 (C. C. A. 8th), certiorari denied, 305 U. S. 639; *Faris* v. *Helvering*, 71 F. 2d 610 (C. C. A. 9th), certiorari denied, 293 U. S. 584; *Baker* v. *Commissioner*, 80 F. 2d 813 (C. C. A. 2d); *Wilcox* v. *Commissioner*, 187 F. 2d 136 (C. C. A. 9th); *Leland* v. *Commissioner*, 50 F. 2d 523 (C. C. A. 1st), certiorari denied, 284 U. S. 656; *Dunton* v. *Clauson* (D. Maine), decided September 27, 1946 (1946 C. C. H., par. 9354).

To the extent that *Bass* v. *Commissioner*, 129 F. 2d 300 (C. C. A. 1st), may be considered at variance with the views herein expressed, we submit that it was incorrectly decided, but in any event it is distinguishable from both the *Bazley* case and the instant one because the transaction was motivated by corporate business reasons; moreover, it did not involve a distribution of debentures but a distribution of preferred stock which seems to have amounted to a nontaxable

stock dividend under *Helvering* v. *Sprouse*, 318 U. S. 604. The court in the *Bass* case appears to have taken the view that where there is an exchange, there can not be a distribution. See 129 F. 2d 300, 308. But, as shown in our brief in the *Bazley* case, such a view is unsound. A distribution cannot be effectively disguised for tax purposes by casting it in the form of a reorganization. There is no magic in the reorganization sections through which taxpayers can change what is plainly income into capital and thus escape taxation. Cf. *Commissioner* v. *Fisher*, 327 U. S. 512.

Here there was no liquidation and hence there is no basis for the application of *Hellmich* v. *Hellman*, 276 U. S. 233, which held that amounts distributed to the stockholders of a liquidating corporation out of earnings and profits accumulated by the corporation since February 28, 1913, are not to be treated as ordinary dividends but as payments made by the corporation in exchange for its stock. The instant corporation, like the one in the *Bazley* case, was a going concern (cf. *Guild* v. *Commissioner*, 19 B. T. A. 1186), and we do not understand that the taxpayer contends otherwise.

The taxpayer contends (Br. 15 ff.) that if the debentures are taxable at all, they should be treated as "boot" under Section 112 (c) and (e)

so that only the gain upon the exchange, viewed as a whole, would have to be accounted for. He says that there was in reality a loss and that the Tax Court's findings are deficient in not showing this. The answer to that contention is that under *Commissioner* v. *Estate of Bedford, supra,* it was certainly open to the courts below to hold, as they did, that the debenture distribution amounted to a dividend to the extent that earnings were available. A distribution in property can qualify as a dividend equally as well as one in cash (*Doerschuck* v. *United States,* 274 Fed. 739 (E. D. N. Y.); II Cook, Corporations (8th ed., 1923), Sec 535, p. 1849), and in the circumstances there was no reason for the Tax Court to consider any questions with respect to capital gain or loss. In view of the conclusion that the issuance of the debentures was a distribution of earnings and profits, such an inquiry was irrelevant.

To the extent that this case can be reduced to its own particular circumstances, and does not turn on a generalizing principle, the Tax Court's determination should be accepted as final under *Dobson* v. *Commissioner,* 320 U. S. 489. The Circuit Court of Appeals below properly took that view. (R. 117.) And see *Commissioner* v. *Estate of Bedford, supra.*

CONCLUSION

The judgment of the court below should be affirmed.

Respectfully submitted,

GEORGE T. WASHINGTON,
Acting Solicitor General.
SEWALL KEY,
Acting Assistant Attorney General.
J. LOUIS MONARCH,
ARNOLD RAUM,
L. W. POST,
Special Assistants to the Attorney General.

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